CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY

How to take advantage of inefficiencies created by index managers

60 seconds with the fund manager

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This marketing communication is intended for non-professional investors.

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Grégoire Thomas, Head of Equity Market Neutral, explains to us how the explosion of the index management market can create investment opportunities for managers who can take advantage of of temporary market inefficiencies.

What is the first observation that led you to develop an index arbitrage strategy in 2003?

Back in 2003, we noticed that index arbitrage was really starting to take off, and this trend has only grown stronger since then.

Today, on average in the developed markets where we focus our attention, index mana gement has grown in scale and scope. The movement has mainly been driven by pension funds allocating capital to the various asset classes at lower cost.

From that standpoint, we were firmly convinced that playing on index readjust ments – taking short positions in names being removed or long positions in names being added during the quarterly index rebalances – would generate opportunities for attractive returns.

How has the strategy's potential evolved in recent years?

Index arbitrage volumes have swelled over the past ten years, in pace with the rapid development of the index tracking industry. We provide liquidity to index managers whenever they have to replicate the read justments by purchasing incoming securities and selling outgoing securities.

These transactions generate substantial additional volumes in these specific secu rities, thus creating price inefficiencies. The addition of a stock to the S&P500, for example, can generate investment flows of some $10 billion and approximately €1 billion on the Euro Stoxx 50. As a conse quence, this universe offers a very deep market.

Our strategy, however, is to allocate only 30% of assets[1] to arbitrage, with the rest of the portfolio consisting of cash instruments. We are perfectly capable of managing hundreds of millions of euros in order to maintain sufficient room to

60 SECONDS
WITH THE FUND MANAGER

(1) Data provided solely for information purposes and likely to change over time.

manoeuvre, but we also want to keep a reasonable amount invested to ensure a satisfactory return.

You wanted to gradually add other strategies to your historic core strategy, index arbitrage. Why did you decide to diversify?

It's true, we set up corporate action and relative value arbitrage strategies. From the beginning our approach combined qualitative and quantitative analyses. A purely qualitative approach, based on inter views with corporate management, gives a sense of the company's business model. For its part, a quantitative model optimised with multiple inputs can give you a multitude of data, but doesn't provide you the required level of understanding in the company lifecycle. So in addition to quantitative backtesting, we also try to get a handle on the rationale of index readjustments. They are often driven by corporate actions (mergers & acquisitions, IPOs, spinoffs, bankruptcies, etc.), which automatically spark largescale buy/sell flows.

It's helpful to understand how these corpo rate actions work and how to take advantage of them. With a public exchange offer, for example, you see arbitrage between the target and the buyer based on the terms of the exchange: fair value is defined based on the likelihood that the exchange will go through. Corporate action arbitrage, which involves identifying securities whose price will be impacted by a specific event, follows on naturally from that.

Another natural step forward is to look at relative value through pair trading, or arbitrage between two companies with the same business via a short position offset by a long position in order to remain market neutral. The goal is thus to benefit from mean reversion on two highly correlated assets. Our observation of additions/deletions within the indices, and their timing give us very good indications on the trends affecting various sectors and various companies, and this has enabled us gradu ally to implement this strategy.

What sets your approach apart from other hedge fund managers which rely on the same strategies?

As regulations have evolved, banks have slightly reduced their proprietary trading, but arbitragists have stepped in the hedge fund universe, so volumes have been maintained.

In the hedge fund universe, some funds based their performance on lowmargin arbitrage strategies boosted with leverage. That's not how we operate. We focus on daily liquidity in a UCITS framework, withlow volatility. The target is to achieve an absolute return ahead of Eonia.

To reach our target, we combine a cash bucket invested in shortterm money market instruments (about 70%[2] of the port folio's assets) with an active investment bucket consisting of discretionary arbitrage strategies in equities and indices. More importantly, we are equity market neutral so we are not impacted by the market environment, because our long and short[3] positions are equally weighted (about 20%[4]): net market exposure cannot exceed 10%[5] and has often been lower than 1%[6] since inception. Finally, the portfolio is highly diversified, with each individual position usually weighting at less than 1%[7] of the portfolio.

(2) Data provided solely for information purposes and likely to change over time.
(3) A long position is a buyer's position, as you are betting on the value of the share to rise. A short position is a seller's position because you expect the price to fall in the future.
(4) Data provided solely for information purposes and likely to change over time.
(5) Data provided solely for information purposes and likely to change over time.
(6) Data provided solely for information purposes and likely to change over time.
(7) Data provided solely for information purposes and likely to change over time.

The main risks of the strategy are:

• Risk of capital loss:

There is no guarantee for investors relating to the capital invested in the strategy in question, and investors may not receive back the full amount invested.

• Sustainability Risk:

The sustainability risk refers to any environmental, social or governance-related event or situation that might affect the performance and/or reputation of issuers invested in.

Sustainability risks may be subdivided into three categories:

• Environmental: environmental events may create physical risks for the companies invested in.

• Social: refers to the risk factors linked to human capital, the supply chain and the way companies manage their impact on society.

• Governance: these aspects are linked to governance structures.

The sustainability risk may be specific to the issuer, depending on its activities and practices, but may also be due to external factors. If an unforeseen event occurs in a specific issuer such as a strike or more generally an environmental disaster, the event could have a negative impact on the performance. In addition, issuers which adapt their activities and/or policies may be less exposed to the sustainability risk.

• Equity risk:

Some strategies may be exposed to equity market risk through direct investment (through transferable securities and/or derivative products). These investments, which generate long or short exposure, may entail a risk of substantial losses. A variation in the equity market in the reverse direction to the positions can lead to the risk of losses and may cause the performance to fall.

• Derivative risk:

Financial derivatives are instruments whose value depends on (or is derived from) one or more underlying financial assets (equities, interest rates, bonds, currencies, etc.). The use of derivatives therefore involves the risk associated with the underlying instruments. They may be used for purposes of exposure or hedging against the underlying assets. Depending on the strategies employed, the use of derivative financial instruments can also entail leverage risks (amplifying downward market movements). In a hedging strategy, the derivative financial instruments may, under certain market conditions, not be perfectly correlated to the assets to be hedged. With options, an unfavourable fluctuation in the price of the underlying assets could cause the strategy to lose all of the premiums paid. OTC financial derivatives also entail a counterparty risk (though this may be attenuated by the assets received as collateral) and may involve a valuation risk or a liquidity risk (difficulty selling or closing open positions).

• Arbitrage risk:

Arbitrage is a technique which consists in benefiting from the differences in prices recorded (or anticipated) between markets and/or sectors and/or securities and/or currencies and/or instruments. If such arbitrage transactions perform unfavourably (a rise in sell transactions and/or fall in buy transactions), the performance may fall.

The risks listed are not exhaustive, and further details on risks are available in regulatory documents.

Find out more about our funds and their risk profiles:

www.candriam.com